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CIA-RDP85T00875R00170001

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CIA-RDP85T00875R00170001

CIA/ER/IM 71-86

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DIRECTORATE OF INTELLIGENCE

Intelligence Memorandum

*Chile: Allende's Moves To Complete The Takeover
Of US Copper Holdings*

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ER IM 71-86
May 1971

Copy No. 66

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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
May 1971

INTELLIGENCE MEMORANDUM

Chile: Allende's Moves To Complete The Takeover
Of US Copper Holdings

Introduction

1. A constitutional amendment to facilitate full copper nationalization has passed the Chilean Congress and should become law in July. The amendment circumvents judicial review of expropriation decisions and, although Congressional modifications in the bill permit some flexibility in negotiating with the companies involved, payment of adequate and timely compensation still appears unlikely. This memorandum discusses the structure of the Chilean copper industry, the role of foreign capital in its development, Chilean government participation in copper operations under agreements negotiated by the Frei administration, and Allende's moves toward full nationalization. It also assesses the potential loss to US companies and other investors, prospects for a negotiated settlement, and Chile's possible financial gains from the takeover.

Conclusions

2. Chile's earnings from its large US-developed copper mines already have increased significantly as a result of the nearly completed investment program and the tax and equity changes effected by the Frei administration. Completing the nationalization process will reap substantial new gains for the Allende government, provided that compensation payments and production shortfalls are limited. Potential gains from abrogating the Frei agreements with the US copper companies would be particularly

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

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large during 1971-73, when capital outflows on accelerated amortization of third-party credits to the expansion program and on the buying out of Anaconda were expected to be high.

3. If Chile is to retain its credit rating in international financial markets, however, the Allende government will have to pay more for the copper properties than it probably had earlier intended. Because third-party capital played a substantial role in financing recent expansion, outstanding loans from the Export-Import Bank and US, European, and Japanese private institutions -- which Allende has publicly stated will be honored -- now exceed \$350 million. If pressed, these creditors might agree to some debt rescheduling, particularly in regard to easing accelerated amortization requirements.

4. Chile will take a hard line on compensating the US copper companies despite some concern about the impact of its actions on potential foreign investors. The companies' investment stake (including the unredeemed Chilean government notes issued to Anaconda) totals an estimated \$550 million at book value -- a substantial understatement of its fair market value. The companies generally are in a weak bargaining position because only slightly more than one-fifth of the total investment book value is covered by US government insurance. Settlements negotiated by the individual companies probably will vary considerably, depending upon the size of the financial stake involved, the insurance coverage, the company's public image in Chile, and its willingness to cooperate with the Chilean government in providing technical and marketing assistance -- perhaps at the expense of the other companies involved.

5. Chile's gains from copper nationalization clearly will depend upon the amount of compensation paid for the properties and the impact of nationalization on copper output. Under the unlikely circumstances that no compensation were paid and no production shortfall occurred -- and assuming that copper prices continue at the recent level of about 55 cents a pound -- copper nationalization could yield Chile some \$1.2 billion more in net foreign exchange than the \$4.6 billion it would

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have earned during 1971-76 under existing agreements. If third-party creditors were paid over the maximum term and the companies compensated at book value, Chile could still gain about \$600 million during this period, provided that production matched the levels expected under company management.

6. But technical difficulties attending the starting up of new facilities already have caused production lags, and production shortfalls are expected to be significantly larger and more prolonged with Chile's takeover. A serious loss of technicians and erosion in labor discipline already has occurred. Should production lag as much as 20% behind planned output -- and this seems likely at least over the next year or so -- Chile would in fact immediately suffer financial losses from nationalization if creditors and companies were compensated. If such a lag persisted, earnings could be some \$600 million lower during 1971-76 than had been expected under existing agreements. A continued output shortfall of 20% would cause losses after 1973 even if no compensation were paid.

7. Even if a negotiated copper settlement is reached, there is of course no assurance that compensation schedules will be met. High copper earnings would make payments easier but by no means certain. Default is most likely to occur if the Allende government judges that such a move would cause less of a loss in new capital received than it is paying out in compensation.

Discussion

The Industry's Importance and Structure

8. Chile vies with Zambia as the Free World's second largest primary copper producer and the world's largest copper exporter. Its 1969 output of 760,000 tons 1/ accounted for some 14% of the Free

1. All tonnages in this memorandum are short tons.

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World's copper mine production and about one-fourth of its copper exports. Chile's known copper reserves are perhaps the largest in the Free World and, because of their high average ore content, production costs are relatively low. The industry provides 75%-85% of Chile's export earnings, about 10% of GNP, and about 20% of government tax revenue. Although the industry employs only about 5% of the industrial labor force, its workers are among the best trained and by far the highest paid in Chile.

9. Foreign investment was essential in developing Chile's copper industry because of the massive capital and advanced technology required. The three largest mines, producing 80%-85% of Chile's copper, were developed by US investors. Chuquicamata, the world's largest open pit mine, and El Teniente, the world's largest underground mine, have been operated by Anaconda and Kennecott, respectively, since about 1920. The considerably smaller El Salvador mine was developed by Anaconda in the late 1950s to replace a nearly depleted mine in the same area. Two new copper mines -- Exotica and Andina - Rio Blanco -- which are being developed by Anaconda and Cerro Corporation, respectively, began producing in late 1970 and are scheduled to reach full production in 1971. Although these mines are currently only small producers, they will soon have substantial output and are included in the five large mines scheduled for expropriation under the constitutional amendment now in the Congress. Chile's most productive medium-size mines also have been developed mainly by foreign capital and include Sagasca (Continental Copper's joint venture with the Chilean government), the German-owned Mantos Blancos, and the French-owned Disputada. (See the map for locations of Chile's eight largest mines.)

The State's Position in the Industry by 1970

10. Thanks to the Frei administration's adroit handling of copper affairs, the government at the time of Allende's accession already owned 51% of the major segments of a newly modernized and expanded industry. Moreover, its combined receipts from dividends and taxes on the five large mining properties had risen to some 85% of gross profits. The government's equity participation began with

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CHILE
Location and Ownership of Large and Medium-Sized Copper Mines



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the 1967 "Chileanization" agreements under which it acquired a 51% interest in Kennecott's El Teniente mine, a 25% interest in Anaconda's Exotica, and a 30% interest in Cerro's Andina - Rio Blanco. The agreements also guaranteed reduced and non-discriminatory tax rates for 20 years in exchange for the companies' participation in a \$600 million investment program designed to increase output substantially by 1972.

11. Less than two years later the Chilean government forced the companies to accede to basic changes in the copper agreements. 2/ Threatened with immediate expropriation, Anaconda agreed to transfer a 51% equity in Chuquicamata and El Salvador on 1 January 1970 and to sell the remaining 49% sometime during 1973-81, at Chile's option. At the same time the Frei government subjected Anaconda's newly nationalized mines to higher tax rates and applied a variable excess profits tax to them as well as to Kennecott's El Teniente mine. This so-called "over-price" tax becomes progressively steeper as copper prices rise above 40 cents per pound and was designed to limit windfall profits from prevailing high prices. The following tabulation shows the government's share of gross profits (after depreciation allowances) resulting from the various tax and equity changes effected by the Frei administration:

	Percent				
	<u>1966</u>	<u>1967</u>	<u>1968</u>	<u>1969</u>	<u>1970</u>
El Salvador (Anaconda)	50.0	49.9	50.0	68.1	87.6
Chuquicamata (Anaconda)	61.1	58.6	57.8	74.6	86.5
El Teniente (Kennecott)	78.5	70.0	72.6	80.0	83.5
Exotica (Anaconda)	--	Not yet	producing	--	55.7
Andina - Rio Blanco (Cerro)	--	Not yet	producing	--	58.4
<i>Weighted Average</i>	67.2	61.9	61.0	75.8	84.6

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12. Despite these radical changes, the companies were forced to continue the investments called for under the 1967 copper agreements. By November 1970, when the Allende government took office, the expansion programs were about 90%-95% completed. As a result of these investments, annual production capacity of the large copper mines will change as follows:

	<u>Thousand Tons</u>	
	<u>1966</u>	<u>1972</u>
El Salvador (Anaconda)	86	110
Chuquicamata (Anaconda)	334	390
El Teniente (Kennecott)	170	280
Exotica (Anaconda)	0	112
Andina - Rio Blanco (Cerro)	0	78
<i>Total</i>	<i>590</i>	<i>970</i>

The investment program also called for substantially increased refining capacity, which will increase the share of higher priced, electrolytic copper, as follows:

	<u>Percent of Total Processed Copper</u>	
	<u>1966</u>	<u>1972</u>
Electrolytic	45.6	65.0
Fire-refined	13.8	12.5
Blister	40.6	22.5
<i>Total</i>	<i>100.0</i>	<i>100.0</i>

Allende's Moves So Far

13. Allende and his Popular Unity Front left no doubt, either before or after the election, that full nationalization of the large copper mines was a priority target. The only question concerned compensation. Because the Chilean constitution

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guarantees that agreements such as those signed by the government and US copper companies can be revised only by mutual consent, the Allende government opted to amend the constitution. Simple congressional expropriation, while faster, would be subject to review and possible over-ruling by Chile's independent and conservative Supreme Court. The proposed amendment has some precedent in Frei's agrarian reform program, which required similar action to exempt land expropriation cases from judicial review.

14. The constitutional amendment sent to Congress by Allende on 22 December 1970 was extremely punitive, virtually assuring that little or no compensation would be paid for expropriated properties. The amendment as modified by the Congress still permits nationalization with little or no compensation but provides some scope for possible negotiation. The Congress also rejected an administration article requiring that compensation arrangements made for large mining companies apply to all basic resources nationalized. While the revised amendment gives the state complete authority over all mines and mineral deposits, it details provisions for expropriation of only the large-scale copper mining industry.

15. The amendment's major provisions as presently written are as follows:

- Upon its enactment, the assets of the five large copper mines become state property, as do the assets of any associated or affiliated companies deemed necessary by the President.
- Compensation is to be determined within 90 days by the government's national accounting office, but this period can be extended an additional 90 days if necessary. Compensation will be based on the book value of assets on 31 December 1970 less revaluations of assets after 1964. This amount will be reduced to reflect unpaid back taxes and penalties, mine depletion, obsolescence, and inadequate servicing. Furthermore, the President is authorized to deduct from compensation "excess profits" obtained by the companies since 1955; Allende could apply this provision in such

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a way that compensation to the two major companies would be nil.

- The companies and the state have 15 days to appeal the compensation decision to a special tribunal composed mainly of political appointees.
- The President will fix conditions of payment over a period not exceeding 30 years, at not less than 3% annual interest. (The original text called for equal payments over 30 years at 3% interest.)
- Past government agreements with the mining companies are no longer considered valid. Amounts already paid on the purchase of Kennecott shares in 1967 and on the \$175 million in notes given Anaconda in 1969 will be deducted from initial payments of the newly determined compensation.
- Compensation payments will be terminated if the companies refuse to turn over studies, plans, reports, titles, data, or other items necessary to current and future operations of if they engage in "obstructionist conduct".

16. The status of third-party creditors -- such as the Export-Import Bank, US and foreign commercial banks, and Japanese companies -- is not clearly stated in the amendment. In fact, the Allende government probably did not fully recognize the importance of third-party capital in Chilean mining operations when it submitted the amendment to the Congress. Only since late February have government spokesmen expressed "surprise" that the joint copper ventures owed large foreign debts and that the US copper companies "had not invested a single fresh dollar" in the expansion program.

17. While these government statements are exaggerated, third-party financing unquestionably has played a major role in the ongoing investment program. The increasingly apparent conflict between its twin goals of acquiring the copper properties for a minimal payment and maintaining its international credit rating at least partly explains Allende's relatively deliberate pace on mining nationalization in recent months.

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ImplicationsForeign Investor Stake Involved

18. A conservative estimate of the financial stake of foreign investors in the five copper mining properties scheduled for expropriation would be nearly \$1 billion. Of this sum, the book value of direct company investment (equity interests plus direct parent company loans to Chilean subsidiaries) is estimated at only some \$390 million. The long-term foreign loans to the joint copper companies are almost as large. These and other elements in the companies' capital structure, as estimated for 30 September 1970, are detailed below:

	Million US \$	
	Capital and Liabilities (Equal to Assets)	Of Which: Foreign Investors' Stake
US companies' direct investments	<u>390</u>	<u>390</u>
Equity	285	
Parent company loans	105	
Chilean government's paid-up equity	<u>155</u>	
Chilean government's equity financed with notes not yet redeemed <u>a/</u>	<u>160</u>	<u>160</u>
Long-term foreign loans	<u>355</u>	<u>355</u>
Export-Import Bank	185	
US commercial banks	86	
European commercial banks	53	
Japanese firms	31	
Short-term credit and accrued taxes	<u>100</u>	<u>75</u>
<i>Total</i>	1,160	980

a. Unredeemed portion of the \$175 million in Chilean government notes given to Anaconda in 1969 as payment for a 51% interest in the Chuquicamata and El Salvador mines.

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19. Repayments on the long-term foreign loans are scheduled to begin in 1971. The Export-Import Bank and Japanese loans carry a maximum repayment period of 15 years at 6% interest, but accelerated amortization features tied to profits could shorten this period considerably. At current copper prices, as much as 90% of these loans would be paid off by the end of 1973. The commercial bank loans carry somewhat higher interest rates and are scheduled to be repaid in six to eight years. With accelerated amortization, debt servicing on all third-party credits would average an estimated \$100 million annually during 1971-73 and then fall to \$25-\$30 million. At a fixed rate over the maximum term, payments would total about \$50 million annually through 1978 and then decline to less than \$20 million.

20. The book value of the companies' investment -- while probably the best the companies can hope to recover -- clearly is much lower than their share of the properties' fair market value, based on either replacement cost or sales value under normal circumstances. Another internationally accepted method of computing market value is to discount future income by applying a multiple earnings factor -- the method accepted by the Frei government in 1969 for the planned purchase of Anaconda's remaining 49% equity. Application of the same formula (a multiple of between six and eight) to projected average net earnings of the companies during 1972-76 would, under present tax and equity arrangements and with a copper price of 55 cents per pound, yield a fair market value of between \$750 million and \$1 billion.

21. Of the three US companies, Kennecott probably would be damaged the least by confiscatory Chilean action. Although El Teniente is a profitable property, it has been treated as a marginal investment for many years. Kennecott in fact did not put any "fresh dollars" into the \$250 million expansion program but simply reloaned to the joint venture the \$80 million plus interest received from the Chilean government for its purchase of a 51% equity in the operation. This loan is fully insured under the US government investment guaranty program. The remainder of the investment program was financed by loans from the Export-Import Bank (\$81 million), Japanese and European sources (\$53 million), and the Chilean government (\$24 million). When the joint

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venture was formed in 1967, El Teniente's assets were revalued substantially upward to reflect their fair market value. If the constitutional amendment provision nullifying all post-1964 revaluations is strictly applied, the Allende government could place a negative value on Kennecott's remaining equity because the price the company received for a 51% share was more than the investment's total book value before revaluation.

22. Cerro Corporation is facing expropriation of its investment just as it begins to earn a return. The \$150 million investment program at the Andina - Rio Blanco mine is being financed by \$42 million in parent company capital and loans, \$19 million from the Chilean government, and \$88 million in loans from the Export-Import Bank and Sumitomo. About 85% of these funds were scheduled to be expended by the end of 1970. Only \$14.2 million of Cerro's investment is covered by US government investment guaranties.

23. Anaconda stands to lose the most, primarily because its Chilean properties bulk large in its operations despite recent attempts to diversify. Its investment program in Chile (including housing construction) totaled almost \$300 million, with about half being financed from company funds and only \$4 million coming from the Chilean government in payment for an equity share in Exotica. Anaconda raised the remaining funds through loans from the Export-Import Bank (\$59 million), European banks (\$24 million), and US commercial banks (\$62 million). Almost all of this financing was arranged while the company had majority control in the enterprises being developed. Although the Chilean government assumed major responsibility for debt servicing when it bought out 51% of the two larger mines, the constitutional amendment now in process could nullify the agreement.

24. The book value of the three properties now owned jointly by Anaconda and the Chilean government probably exceeds \$400 million. The \$175 million price agreed upon in mid-1969 for Chile's purchase of a 51% interest reflected fairly closely the properties' book value (with no upward revaluation) at that time. Anaconda's acceptance of less favorable terms than Kennecott had received in 1967

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was predicated on the promise of a better return on the remaining 49% equity under the multiple earnings formula. In the interim, of course, the properties' book value has continued to rise as expenditures under the expansion program were made. In case of expropriation, Anaconda is assured of only \$22.5 million in coverage under the investment guaranty program. The US government is contesting the validity of an additional \$247 million in coverage that the company claims.

Chances of a Negotiated Copper Settlement

25. The constitutional amendment as it finally emerges from the Congress will leave the Allende administration a considerable degree of flexibility in making decisions on expropriation terms. Moreover, it may decide to negotiate with the companies during the two-month waiting period before the Congressional legislation becomes effective. Chilean officials are hard at work weighing the costs and benefits of alternative expropriation terms. Factors that will influence the Allende administration's decisions include the following:

- A desire to keep its options open regarding investments, loans, and economic assistance from Free World sources.
- A preference, at least for the time being, to avoid an open break with the United States.
- Its calculation of domestic political benefits and costs deriving from a hard stand against the copper companies and the United States.
- The possible usefulness of the companies' continued cooperation in technical and marketing matters.
- A desire to minimize the economic costs of compensation.

26. Allende apparently considers it highly desirable -- if not essential -- to retain the confidence of international agencies and foreign banks and firms, particularly in Western Europe and Japan. He has stated publicly that the interests of third-party creditors of the copper enterprises will be protected, while blaming the US companies

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for saddling the country with these debts. Chile probably will forcefully press its case for a re-scheduling of these debt service payments, however, and in particular will seek relief from the accelerated amortization procedures incorporated in the most important credit agreements. Because these accelerated payments are based on profit statements that will be drawn up by the Chilean government after expropriation, the creditors involved may deem it pointless to be inflexible on the matter.

27. The Allende government can be expected to take a much harder line with the copper companies. Although it has shown greater flexibility than expected in negotiating takeover terms with various US manufacturing firms and with Bethlehem Steel, this does not necessarily presage a similar settlement with the copper companies. The Bethlehem Steel and copper company cases differ in several essential respects. Adequate compensation for the copper holdings would involve much larger outlays. Moreover, copper nationalization is a highly sensitive political issue in Chile, and the Allende government will not want to appear guilty of being too lenient with the companies. Perhaps most important, Bethlehem Steel was in an excellent bargaining position by virtue of its investment guaranty coverage. The desire to avoid an early confrontation with the US government undoubtedly affected the Allende government's posture. At the other extreme, US government denial of the validity of most of Anaconda's coverage is publicly known and may lead the Allende government to believe that confrontation is unlikely even if compensation is inadequate. Current investment guaranty coverage for all three copper companies totals only \$121 million, compared with the \$550 million book value of company investment plus the unredeemed portion of the notes issued to Anaconda.

28. The expected negotiations will be difficult -- assuming that Chilean political circumstances do not trigger unilateral action. Our best guess at this point is that the Allende administration will generally hold to a compensation price below book value and insist upon stretching payments over a period of 20 years as well as other terms considerably less favorable to the copper companies than those offered other foreign firms. Because Cerro has just

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begun to earn a return on its property and its investment is relatively small, it probably will be given special consideration on both price and terms. Also, the 15-year repayment period on Kennecott's loan to El Teniente probably will be honored, largely because of its US government insurance coverage. The 1969 contract with Anaconda, however, almost certainly will be abrogated in at least two important respects: (a) the requirement that three-fifths of the \$175 million sales price for the first 51% share be paid before purchase of the remainder and (b) the agreement to base the price for the 49% share on a multiple earnings formula. Moreover, it is unlikely that the company's new investments will be treated as favorably as that of Cerro Corporation.

29. Other considerations may also contribute to disparities among the settlements received by the three copper companies involved. If willing to cooperate with possible Chilean efforts to play one investor off against the other, an individual company could substantially improve its bargaining position. For example, the Allende government almost certainly realizes that its future mining operations would benefit from continued access to US technical and marketing assistance and may be willing to negotiate more favorable compensation terms to obtain such company services. It is least likely to choose Anaconda for this role because the company's financial stakes are the largest, and justifiably or not, its public image in Chile is the worst. Cerro would appear to be the most acceptable on both counts, but Kennecott's extensive experience with Chilean mining operations and good relations in the past with the government may give it an inside track.

Chile's Potential Gains from the Takeover

30. Because the expansion program is nearly complete and debt repayment just beginning, Chile will be taking over the large mines at an ideal time from the point of view of capital flows. Gross investment inflows under the program are scheduled to decline from an average of \$150 million annually during 1968-70 to less than \$20 million in 1971. At the same time, remittances of dividends and depreciation allowances and debt servicing

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payments are scheduled to increase from an average of \$135 million in 1968-70 to \$255 million in 1971. Assuming that the Chilean government would have opted to buy out Anaconda's remaining equity at the earliest date permitted under the 1969 agreement, total capital outflows would have jumped to \$320 million in 1972 and then declined to about \$215 million in 1973 and an average of \$155 million annually in 1974-75. 3/

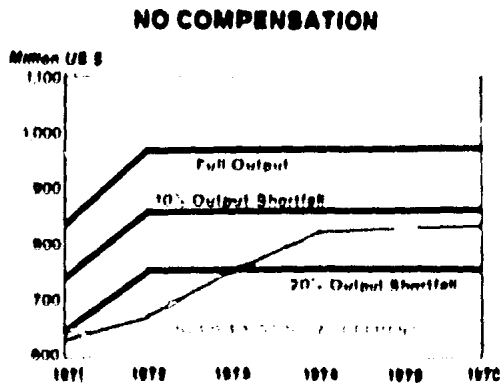
31. If the 1969 agreements were adhered to, Chile's net foreign exchange earnings from large copper mine operations would rise steadily from an estimated \$623 million in 1971 to about \$840 million in 1976 and total almost \$4.6 billion for the whole period (see the chart). In the unlikely case that Chile nationalizes all large copper mines with no compensation to the companies and no payments to third-party creditors, its net foreign exchange earnings could total as much as \$1.2 billion more for the same period. Its gains from such a move would be largest during the early part of the period, when payments arising from accelerated amortization of loans from third-party creditors and from buying out Anaconda were expected to be high. If third-party debts are honored over the maximum repayment period (no accelerated amortization), Chile's gains still could total about \$900 million over the next six years. Its gains could exceed \$600 million even if the companies generally are compensated at book value over 20 years at an average interest rate of 4.5%, with Cerro receiving preferred treatment through payment over 12 years at 5.75% interest and Kennecott's loan to El Teniente being honored on its original terms of 15 years at 5.75% interest.

32. Production shortfalls, however, almost certainly will hold Chile's net gains from nationalization below these levels. The mine takeover will come just as new facilities are starting up and technical difficulties are at their greatest.

3. *All estimates of capital flows and earnings under existing agreements are based on a copper price of 55 cents a pound and an output of 840,000 tons in 1971 and 970,000 tons from 1972 on.*

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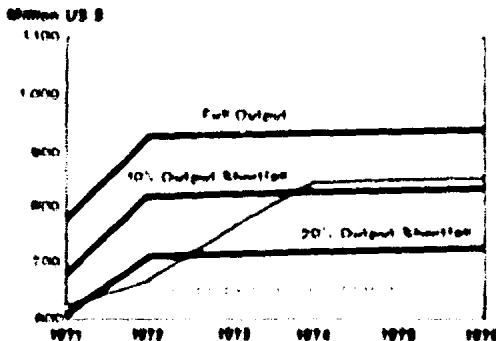
CHILE
Projected Net Foreign Exchange Earnings from Large Copper Mines



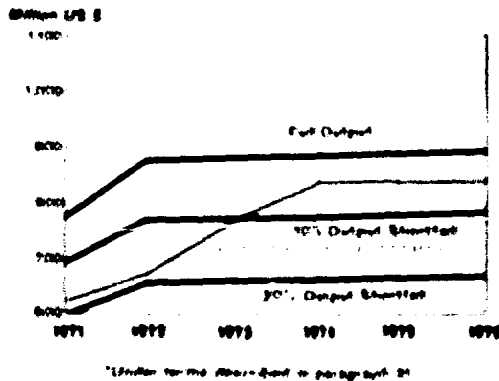
ASSUMPTIONS

- Full nationalization of the properties
- Copper price continuing at recent level of 55 cents per pound
- Copper production at or below capacity, as indicated
- Compensation arrangements, as indicated

THIRD-PARTY CREDITORS PAID OVER MAXIMUM REPAYMENT TIME



COMPANIES COMPENSATED* AND THIRD-PARTY CREDITORS PAID OVER MAXIMUM REPAYMENT PERIOD



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Even under company management, technical problems have caused production shortfalls, and planned targets would not have been met before 1972. Under the best of circumstances, 1971 output would be about 10% below the 930,000 tons originally planned. Because of the imminent Chilean takeover and the loss of technicians and poor labor discipline since Allende's election, the companies now expect 1971 output to be 30% lower than planned. Loss of US material, technical, and managerial assistance should significantly delay reaching the full output level of 970,000 tons scheduled for 1972.

33. If nationalization induced a 10% shortfall in output, Chile would still enjoy a gain in net foreign exchange earnings throughout the 1971-76 period, provided it paid no compensation of any kind. Under this circumstance, even a 20% shortfall would not, until 1974, reduce earnings from a totally nationalized industry below those provided under the 1969 agreements. If third-party debts are honored, Chile still would not suffer a financial loss from nationalization until 1973, if a 20% shortfall occurred, or until 1974 with a 10% shortfall. If Chile also paid the copper companies on the above-described terms (paragraph 31), however, it would immediately suffer financial losses if production fell 20% below planned levels. If output lagged by this amount through the period, Chile's cumulative losses from nationalization during 1971-76 would exceed \$600 million. Under these compensation terms, even a 10% output shortfall would permit Chile to gain from nationalization only during the first two years.